Country Risk Analysis

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SCHOOL OF BUSINESS ADMINISTRATION IN KARVINA

Ing. Jana Šimáková, Ph.D.
simakova@opf.slu.cz

Country Risk

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- Country risk is the potentially adverse impact of a country's environment on an MNC's cash flows and therefore its value.
  - Country risk analysis can be used to monitor countries where the MNC is currently doing business. If the country risk level of a particular country begins to increase, the MNC may consider divesting its subsidiaries located there.
  - MNCs can also use country risk analysis as a screening device to avoid conducting business in countries with excessive risk.
  - Country risk analysis is not restricted to predicting major crises. An MNC may also use this analysis to revise its investment or financing decisions in light of recent events.
- Country risk can be:
  - Political
  - Econonomic and financial

Forms of Political Risk (1)

- Attitude of consumers in the host country
  - a tendency of residents to purchase only locally produced goods.
- Actions of the host government
  - A host government might impose pollution control standards and additional corporate taxes, as well as withholding taxes and fund transfer restrictions.
- Blockage of fund transfers
  - A host government may block fund transfers, which could force subsidiaries to undertake projects that are not optimal (just to make use of the funds).
- Currency inconvertibility
  - Some governments do not allow the home currency to be exchanged into other currencies.

Forms of Political Risk (2)

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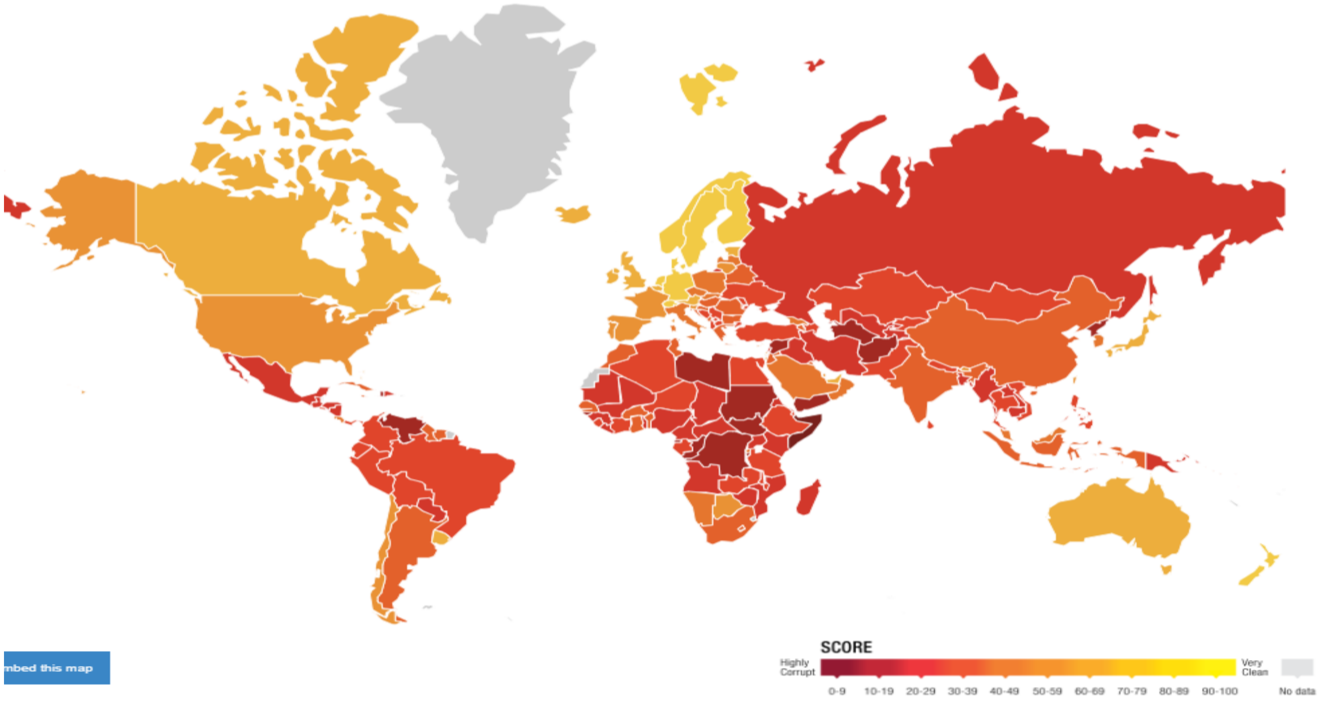
- War
  - Conflicts with neighboring countries or internal turmoil can affect the safety of employees hired by an MNC's subsidiary or by salespeople who attempt to establish export markets for the MNC
- Inefficient bureaucracy
  - Bureaucracy can delay an MNC's efforts to establish a new subsidiary or expand business in a country.
- Corruption
  - Corruption can occur at the firm level or with firm-government interactions. Transparency International has derived a corruption index for most countries (see www.transparency.org).

Corruption Perceptions Index



https://www.transparency.org/cpi2019

Economic and Financial Risks

- A group of economic and financial risks involves the risks of the economy, the financial system or business partners in the host country.
- The macroeconomic environment covers mainly:
  - Economic growth
  - Interest rates
    - higher interest rates tend to slow growth and reduce demand for MNC products
  - Exchange rates
    - strong currency may reduce demand for the country’s exports, increase volume of imports, and reduce production and national income.
  - Inflation
    - inflation can affect consumers’ purchasing power and their demand for MNC goods.

Methods of Country Risk Analysis in MNC

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- Checklist approach
  - ratings assigned to various factors
- Delphi technique
  - collection of independent opinions without group discussion
- Quantitative analysis
  - use of models such as regression analysis
- Inspection visits
  - Meetings with government officials, business executives, and consumers to clarify risk.
- Combination of techniques
  - many MNCs have no formal method but use a combination of methods.

Macro Assesment of Country Risk

- The country's macroeconomic risk estimate is the country's overall risk assessment and includes an assessment of all the variables that affect the country's risk, with the exception of those unique to a particular company or industry.
  - This type of assessment is appropriate in the sense that it remains the same for the country, irrespective of the company or industry concerned.

Micro Assesment of Country Risk

- The country's microeconomic risk estimate includes the country's assessment of the specific type of MNC business.
  - A specific form of country risk may affect the MNC in different ways and therefore a country risk microassessment is needed.

External Sources of Information

- Statistical databases
- Reports by international organisations
- Information from representative offices
- Information from specialised information agencies
- Information from enterprises engaged in international economic activities
- Information from banks, insurance companies and other entities providing funding and risk insurance

Rating

- Globalization and the need to analyze the country's risk have also led to the development of information services and specialized institutions that provide rating services.
- Rating agencies regularly analyze the factors influencing the political and economic situation of the countries and some of their business and non-business entities and assess their credit.

- The most important credit rating agencies are:
  - Moody's (www.moodys.com)
  - Standard & Poor's (www.standardandpoors.com)
  - Fitch (www.fitchratings.com)

Rating Evaluation of Individual Countries

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MOODY'S		STANDARD & POOR'S		Fitch
Investment grades				
Aaa	Germany, Netherlands, USA, Switzerland, Norway, Denmark, Sweden, New Zealand, Canada, Singapore, Australia, Luxembourg	AAA	Germany, Netherlands, Norway, Switzerland, Singapore, Denmark, Canada, Australia, Sweden, Lichtenstein, Luxembourg	Germany, Netherlands, Norway, USA, Switzerland, Singapore, Denmark, Sweden, Canada, Luxembourg, Australia
Aa1	Austria, Finland	AA+	Austria, Finland, Hong Kong, USA	Austria, Finland
Aa2	France, Hong Kong, S. Korea, Kuwait, United Kingdom	AA	Belgium, France, S. Korea, Kuwait, New Zealand, United Kingdom	Belgium, France, Hong Kong, Kuwait, New Zealand, S. Arabia, United Kingdom
Aa3	Belgium, Chile, **CZECH REPUBLIC**, Katar, Taiwan	AA-	**CZECH REPUBLIC**, Estonia, Israel, Qatar, Slovenia, Taiwan	**CZECH REPUBLIC**, Estonia, S. Korea

Rating Evaluation of Individual Countries

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MOODY'S		STANDARD & POOR'S		Fitch
Investment grades				
A1	China, Estonia, Israel, Japan, S. Arabia	A+	Chile, China, Ireland, Japan, Slovakia	China, Chile, Ireland, Israel, Malta, Slovakia, Taiwan
A2	Ireland, Malta, Poland, Slovakia	A	Iceland, Lithuania	Iceland, Japan, Slovenia
A3	Iceland, Latvia, Lithuania, Malaysia, Mexico	A-	Latvia, Malaysia, Malta, Poland, S. Arabia, Spain	Latvia, Lithuania, Malaysia, Poland, Spain
Baa1	Slovenia, Spain	BBB+	Mexico	
Baa2	Bulgaria, India, Indonesia	BBB	Hungary, Italy, Portugal, Indonesia	Bulgaria, Hungary, Indonesia, Italy, Kazakhstan, Mexico, Portugal, Russia
Baa3	Hungary, Italy, Kazakhstan, Portugal, Romania, Russia, S. Africa	BBB-	Bulgaria, Croatia, Cyprus, India, Kazakhstan, Romania, Russia	Croatia, India, Romania

Rating Evaluation of Individual Countries

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MOODY'S		STANDARD & POOR'S		Fitch
Investment grades				
Non-Investment grades				
Ba1		BB+	S. Africa	Cyprus, Northern Macedonia, Serbia, S. Africa
Ba2	Brazil, Croatia	BB	Serbia, Vietnam	Brazil, Turkey, Vietnam
Ba3	Cyprus, Serbia, Vietnam	BB-	Brazil, Northern Macedonia	Greece
B1	Albania, Greece, Montenegro, Turkey	B+	Albania, Greece, Montenegro,Turkey	Mongolia
B2		B	Argentina, Belarus, Bosna, Egypt, Ukraine	Belarus, Egypt, Ukraine
B3	Belarus, Bosnia, Egyp, Moldova, Pakistan	B-	Mongolia, Pakistan	Pakistan
Caa1	Mongolia, Ukraine	CCC+		
Caa2	Argentina, Cuba	CCC		Argentina
Caa3		CCC-		

Country Risk Classification by OECD

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- A group of country risk experts from Export Credit Agencies meets several times a year to update the list of country risk classifications.
  - These meetings are organised so as to guarantee that every country is reviewed whenever a fundamental change is observed and at least once a year.
  - The list of country risk classifications is publically available and published on the OECD website after each meeting; however the meetings themselves and the exchanges and deliberations that take place are strictly confidential.

  - Most recent data are available here:

http://www.oecd.org/trade/topics/export-credits/arrangement-and-sector-understandings/financing-terms-and-conditions/country-risk-classification/

Country Risk Classification Methodology by OECD

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- The Country Risk Classification takes place through the application of a two-step methodology:
  - A quantitative model constructed specifically for this purpose: The Country Risk Assessment Model (CRAM) produces a quantitative assessment of country credit risk based on three groups of risk indicators (the payment experience reported by the Participants, the financial situation and the economic situation based primarily on IMF indicators).
  - A qualitative assessment of the CRAM results by country risk experts from OECD Members in order to integrate factors not fully taken into account by the model. This could lead to an adjustment (upwards or downwards) of a country compared to the CRAM results. Any adjustment has to attract a consensus among Experts. More information available in the operational procedures for the Country Risk Experts Group (December 2017 revision).

Questions and Applications

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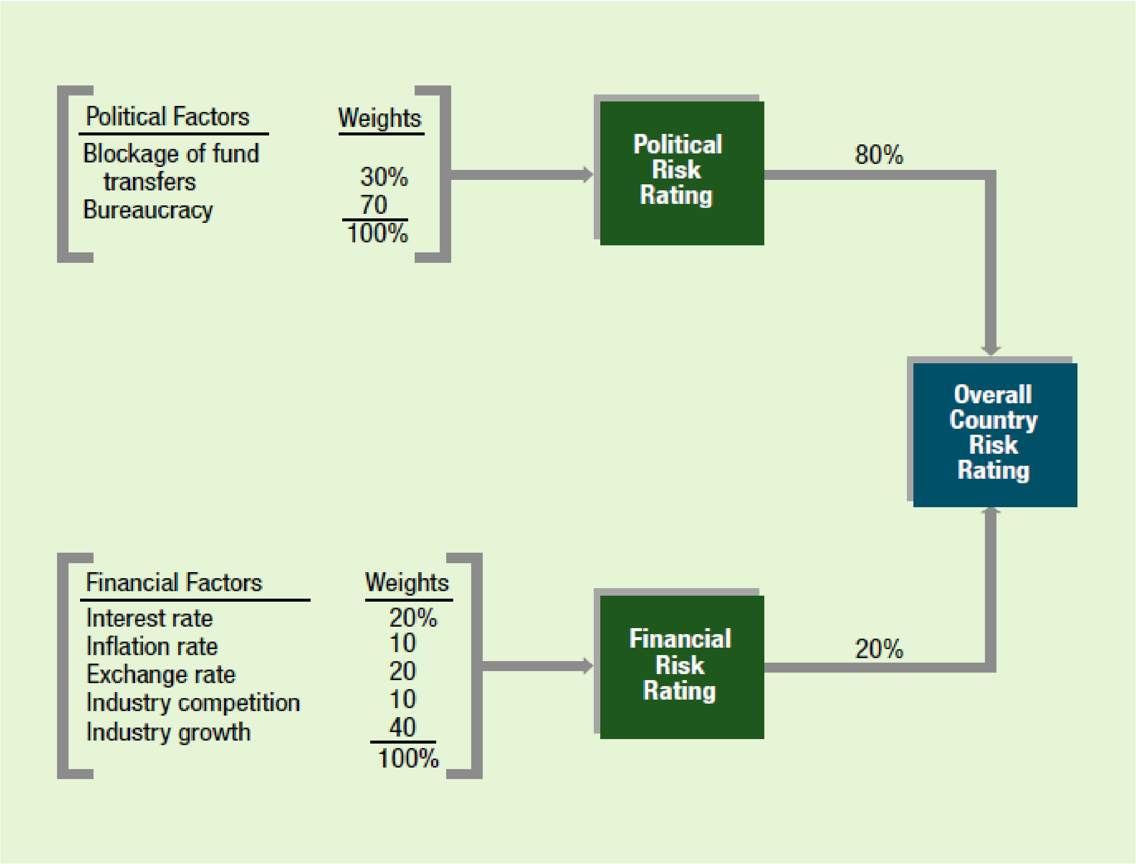
Check the most recent data provided by international institutions to describe the country risk in one European, one Asian, one American, one African country.

An Overall Country Risk

- An overall country risk rating using a checklist approach can be developed from separate ratings for political and financial risk.
  - The political factors are assigned values within some range
  - These political factors are assigned weights. The assigned values of the factors times their respective weights can then be summed to derive a political risk rating.
  - The process is repeated to derive the financial risk rating.
  - Once the political and financial ratings have been derived, a country's overall country risk rating as it relates to a specific project can be determined by assigning weights to the political and financial ratings according to importance.

Determining the Overall Country Risk



Note: The importance of political risk and financial risk varies with the intent of the respective MNC. For instance, MNC considering foreign direct investment to attract demand in that country must be highly concerned about financial risk. MNC establishing a foreign manufacturing plant and planning to export the goods from there should be more concerned with political risk.

Preventing Host Government Takeovers

- Use a short-term horizon
- Rely on unique supplies or technology
- Hire local labor
- Borrow local funds
- Purchase insurance
- Use project finance

Governance of the Country Risk Assessment

- MNCs need a proper governance system to ensure that managers fully consider country risk when assessing potential projects.

- One solution is to require that major long-term projects use input from an external source (such as a consulting firm) regarding the country risk assessment of a specific project and that this assessment be directly incorporated in the analysis of the project.

Comparing Political and Financial Ratings

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- One approach to comparing political and financial ratings among countries is a foreign investment risk matrix (FIRM) that displays the financial (or economic) and political risk by intervals ranging across the matrix from "poor" to "good."
  - Actual Country Risk Ratings across Countries - MNCs need to periodically update their assessments of each country where they do business.
  - Impact of the Credit Crisis - Many countries experienced a decline in their country risk rating due to the credit crisis in 2008. Countries especially reliant on international credit were adversely affected when credit was difficult to access.

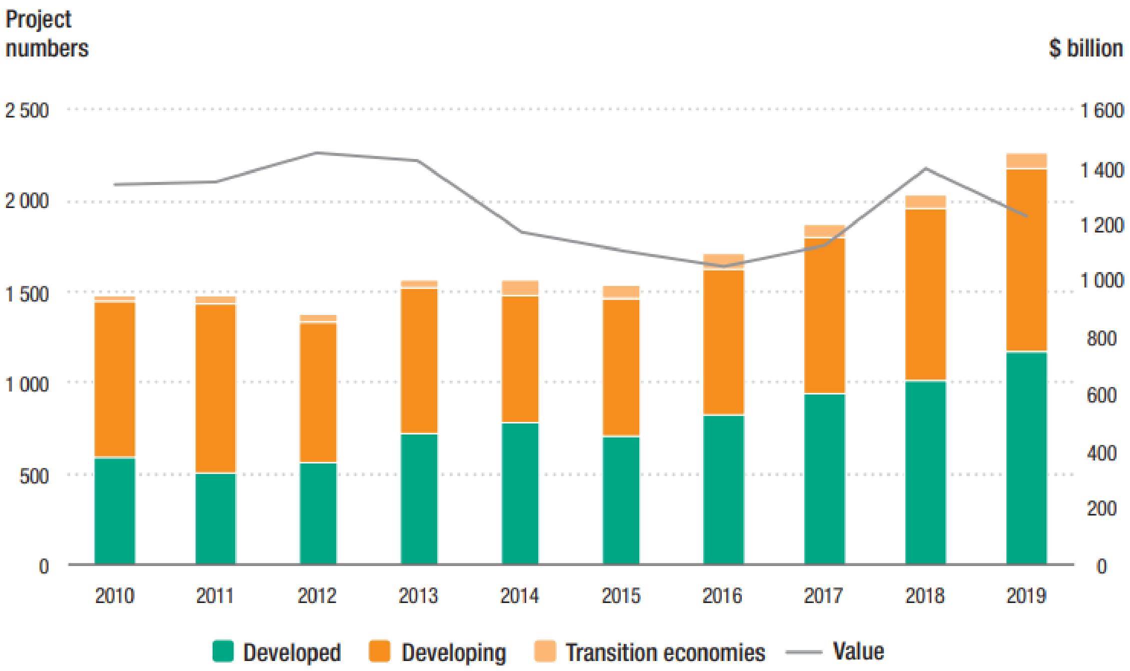
Incorporating Risk in Capital Budgeting

1. Adjustment of the discount rate
   – lower risk rating implies higher risk and higher discount rate.

2. Adjustment of the estimated cash flows
   – adjust estimates for the probability that cash flows may not be realized.

3. Assessing Risk of Existing Projects
   – review country risk periodically after project has been implemented.

Project Financing by Country Development



Source: UNCTAD, based on Refinitiv SA.
Note: All announced projects excluding cancelled; all industries by date of announcement. The value of the project is estimated for about a third of cases.

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